Covered Call ETFs and Taxes: What You Need to Know

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Among the benefits that investors can hope to realize by utilizing ETFs within their portfolios, tax efficiency is one most coveted. It stems, in general, from the in-kind creation/redemption process that typically allows the fund to enter and exit positions without triggering a taxable event for the investor. However, the tax efficiency that can be afforded by the ETF structure can run even deeper depending upon the specific types of securities that the ETF is seeking to hold. Funds designed to incorporate options to perform covered call trades can be a good example of this special situation, being granted the opportunity to elect mixed-straddle tax treatment. It is important to consider, however, how the tax treatment of covered call premiums relates back to the distribution requirements of 40-Act funds (a category that includes ETFs), to maintain a clear picture of the potential tax treatment of distributions.

Key Takeaways

- Aiming to provide investors with an array of structural benefits, most exchange traded funds seek registration under the Investment Company Act of 1940. Once designated as a 40-Act fund, however, the security is subject to specific requirements that may ultimately influence the tax treatment of returns.
- When employing index options to operate a covered call strategy, investors are afforded the opportunity to elect the mixed straddle income taxation approach. This approach has the potential to be tax advantaged and fundamentally differs from the tax treatment of alternative derivative instruments.
- Evaluating a series of cases, the variety of implications associated with harnessing the mixed straddle taxation approach within the ETF structure can be made evident.

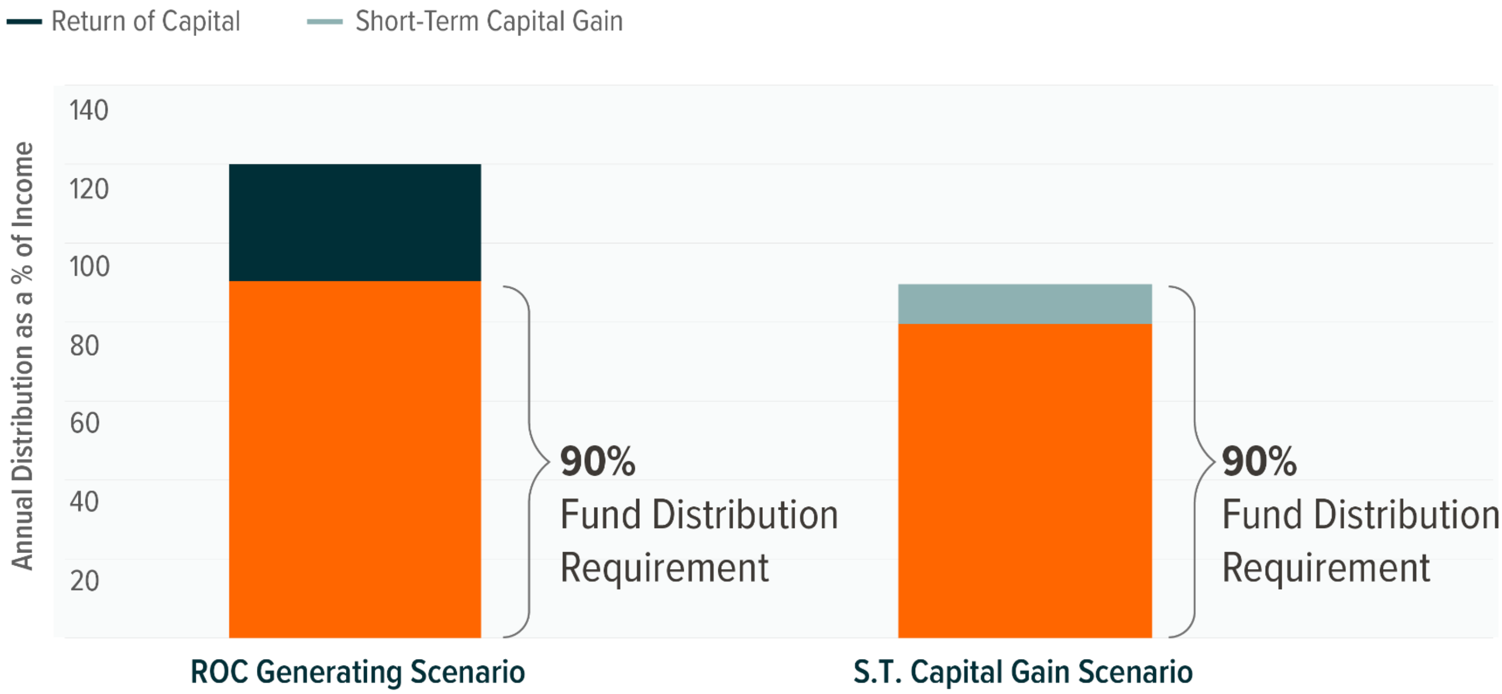
40-Act Fund Obligations Create a Unique Dynamic When Seeking Derivative Income

Operating within the ETF structure, funds registered under the 40-Act are subject to certain requirements, one being that they must distribute at least 90% of their taxable income to their respective shareholders. With this requirement in effect, a scenario is created where accounting for such income becomes increasingly important, and any discrepancy that exists by year-end will need to be rectified. Under the instance that a fund has distributed more than what is technically required, an investor will likely be able to recognize a portion of the excess distribution beyond the 90% threshold as a return of capital (ROC) on their 1099. On the other hand, if the fund ultimately distributes less than what is required as a 40-Act, it will need to perform a one-time capital gains distribution at year-end to catch up.

What is a Return of Capital (ROC) Distribution?

For a distribution to be characterized as a ROC, it generally stems from a fund distributing more than what is theoretically required by the abovementioned 40-Act rules. Being treated as a return of the shareholder's original investment, the return of capital represents a reduction of the cost basis of that original investment. An investor is only taxed on this income, on a capital gains basis, when the value of that original investment has been exhausted to zero or if the investment is sold.

INVESTIGATING SCENARIOS THAT RESULT IN ROC OR SHORT-TERM CAPITAL GAINS DISTRIBUTIONS



Sources: Global X ETFs

Typically, funds that are designed to source income from dividends or bond coupons are able to avoid ROC or year-end capital gains distributions, as their targeted holdings give them a good idea of the measure of income they stand to collect over the course of a given year. Funds that operate derivative strategies like covered calls (or BuyWrites), however, can have a more difficult time pinpointing the balance of premium returns that they can expect to receive. Moreover, distributions stemming from their underlying equity holdings may still factor into this calculation. To smooth out the process, issuers such as Global X maintain a distribution policy whereby a fund will pay out the lesser of half the monthly premium it receives or 1% of its total NAV. The policy aims to create a steady stream of premium returns, as well as provide support to fund NAV via reinvestment. However, this deviation from actual premiums received can lead to mismatches relative to the 90% 40-Act requirement, and so some portion of their distributions may be recognized as ROC.

BuyWrite Funds Utilizing Index Options May Receive Preferential Tax Treatment

Beyond the convenience and cost-effective nature of index options, which is born from their deep liquidity and soft volatility relative to individual stock options, their treatment as 1256 contracts under the U.S. tax code is a benefit that might also be worth investors' consideration. Being characterized in this way, the option contracts become eligible for use in the Mixed Straddle taxation approach within the wrapper of an ETF, which may allow their positive returns to be taxed under a 60%/40% long-term/short-term capital gains split.

RATIONALIZING THE TAX TREATMENT OF COVERED CALL COMPONENTS

Components of a Mixed-Straddle Eligible Covered Call		
Holdings	Purchase Stock (Long)	Sell Index Call Option (Short)
Designation	Non-§1256 Security	§1256 Contract
Tax Treatment	Short Term Capital Gains (Losses)	60% Long Term/ 40% Short Term Capital Gains (Losses)

Sources: Global X ETFs

Operating a covered call strategy, an investor is taking a long position on underlying equity holdings and a short position on a call option. When electing the mixed straddle, there is a freeze placed on the holding period of the underlying equities once these offsetting positions are established. This leaves all of their returns to be characterized as short-term capital gains (losses). However, when seeking to determine what measure of distribution the fund will be subject to under 40-act rules, the mixed straddle will see these non-1256 contract (equity) short-term gains (losses) marked to market on a daily basis and then netted against the gains or losses experienced by the 1256 contracts (the options). At the end of the year, a running total is generated to make the determination surrounding required distributions and, whether or not the fund experienced gains, it will determine the degree to which the 1256 contracts and non-1256 securities are respectively responsible for those gains. The distributions will be taxed accordingly, with gains (losses) from the 1256 contracts experiencing the 60%/40% long-term/short term capital gains treatment, and the gains (losses) experienced by the non-1256 securities being recognized as short term capital gains (losses). When engaging in this process, a distribution policy like the aforementioned one maintained by Global X, can help establish a basis for distributions, given that it is unlikely the issuer will be able to quantify the full impact of the income attributable to the fund until year's end.

Mixed straddle taxation differs materially from the standard tax treatment that funds might experience if they are using individual equity options, FLEX options, or equity-linked notes to operate their covered call strategies. In most cases, the distributions from those securities will be taxed at ordinary income rates, which are as high as 37% for high-net-worth households within the U.S. This compares to the 20% long-term capital gains rate in the top income bracket. Utilizing the mixed straddle, roughly 60% of the potential income generated from the sale of 1256 call options stands to be treated at the latter rate rather than the former.

Investors Can Potentially Rationalize Likely Tax Implications Based on the Direction of the Market

With the basis surrounding the mixed straddle tax election established, something worth considering is how to account for the daily netting of 1256 contracts and non-1256 securities that takes place over the course of a year. After all, there are a variety of scenarios that could theoretically play out on any given trading day, and they could result in either positive or negative net returns. What's more, it's important to determine which portion of the trade accounted for the net gain or loss, and to what extent, given that both legs could theoretically gain or lose value in concert. There are six identifiable scenarios that can take place on a given day, highlighted below, triggered by a combination of market movements and changes in volatility that can influence the value of the options. However, investors may not have the time or wherewithal to keep stock of these daily totals in order to keep up on their anticipated tax burden. Fortunately, given the offsetting nature of the option and equity positions, two scenarios are deemed most likely and can paint a relatively accurate picture of what an investor might expect.

EVALUATING DAILY NETTING SCENARIOS UNDER THE MIXED STRADDLE ELECTION

	Daily Fund Return			Tax Treatment of Return	
Scenario	§1256 Return	Non-§1256 Return	Net Gain (Loss)	Short Term	Long Term
1	-1,000,000	1,500,000	500,000	500,000	-
2	100,000	-300,000	-200,000	-200,000	-
3	2,000,000	-400,000	1,600,000	640,000	960,000
4	-1,000,000	500,000	-500,000	-200,000	-300,000
5	100,000	2,000,000	2,100,000	2,040,000	60,000
6	-500,000	-200,000	-700,000	-400,000	-300,000

Source: Global X ETFs. For illustrative purposes only – does not reflect actual investment performance.

Scenario #1, as outlined in the above graphic, is one in which markets are trending upward over the course of a given year. In this instance, while the impact of each day may be quantified in its own right, an investor can frequently expect that the value of their non-1256 equity holdings will have appreciated. Meanwhile, the written call option has likely moved into the money, thereby losing value. The equity holding is likely to have provided more value than the option had lost. As such, the majority of days in an upward trending market will see the investor taxed on a short-term capital gains basis. This is a situation that likely occurred frequently in 2024, a calendar year in which the S&P 500 delivered a total return of 25%.[1]

On the other hand, if the covered call's reference index is trending negatively, one would expect the opposite, with the premiums from the shorted call options being realized and the option remaining out of the money. Here, as outlined in Scenario #2, the equities are still likely to recognize a loss that exceeds the value of the gain realized by the 1256 contracts, and the investor would ultimately recognize a short-term loss.

How these values are recognized on a tax return calls back to whether or not an annualized gain was realized by the fund at all. In Scenario #1, a gain is to be expected. However, when basing distributions on an existing policy, the fund stands to have generated enough income that it would exceed the value of its performed distributions in an upward trending market by year's end. In that instance, a one-time capital gains distribution would likely be necessary in order to reach the 90% threshold and remain in compliance with 40-Act rules. In scenario #2, the fund's established distribution policy will likely have seen it distribute more than what would have theoretically been necessary, since it is losing value on its equity holdings, and so a portion of the distributions made beyond the 90% threshold would likely be recognized as ROC.

This is a situation wherein electing the mixed straddle is especially helpful, as it may provide a modicum of a tax break to the investor in years where they have already experienced a loss. Operating the strategy utilizing a different kind of derivative instrument might leave the investor in a position to experience losses on the fund and then be taxed at ordinary income tax rates on their distributions all the same.

Depending Upon Their Structure, Covered Call ETFs Can Represent Tax-Advantaged Vehicles

Diving into the tax implications associated with what are widely recognized as more-advanced investment strategies can be a chore. However, when screening out investment opportunities that seek to accomplish similar goals, such as covered call funds, the tax treatment of their returns may end up representing a deciding factor. Funds that utilize index options to establish their positions are afforded the ability to harness the mixed straddle taxation approach, an election that provides multiple potential benefits including preferential tax treatment on premium distributions and the opportunity to defer tax burdens in falling markets by recognizing returns as return of capital distributions.

Footnotes

1. Bloomberg L.P. S&P 500 total returns from December 31, 2023 to December 31, 2024. Data retrieved January 30, 2025.
